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FEDERAL TAXES UPON INCOME AND EXCESS PROFITS— DISCUSSION

E.M. PATTERSON.—In discussing this topic three assumptions may be made. First, the war will in all probability be a long one, extending over several years. If by any chance this is wrong we may at least be certain that we should prepare for an extended struggle. By so doing we shall not prolong the conflict, but shall probably shorten it. Second, the costs are likely to be greater than present estimates, instead of less, and to increase as time passes. This has been true in other countries and will doubtless hold with us. We may not spend this year all of the nearly \$19,000,000,000 appropriated, but actual expenditures in successive years will increase.¹ Third, the money we need must be raised within the United States. Our allies may have borrowed and may continue to borrow outside their own borders, but no such resources are open to us.

These facts are clear and are staggering in themselves. Yet they must be supplemented by other considerations almost as important. Comparisons with other wars, such as the Napoleonic, are often made and for some purposes are most valuable, but certain changes have come over our economic life during the last one hundred years. This war is more violent, more extensive, and more destructive than any that have preceded it and is being waged in a world unlike that of the previous century. Two changes only will serve as illustrations. One is the fact of large-scale business organization. Hundreds of millions of invested capital and tens of thousands of employees are frequent. But large capital investments mean overhead expenses that are huge both absolutely and as compared with total expenditures. Under these conditions, competition means inevitable disaster; and with or without legal approval it tends to disappear. We may not desire it, may even protest against it, but the fact remains. In times of peace this furnishes numerous and difficult problems which in time of war are aggravated and supplemented with others. In peace our chief concern is over the dangers of monopoly control. Now these dangers are intensified and to them are added the difficulties brought on by a rapidly altered demand. War needs increase the power of a monopoly controlling necessities. At the same time, they make precarious the situation of those large industries which manufacture or deal in non-

¹ Since this was first written, it is reported from Washington that appropriations by Congress for the next fiscal year may exceed \$25,000,000,000. This may be inaccurate but is in line with the opinion expressed above.

essentials. With a decreased demand for their services they face losses that are all the heavier because their investments in fixed and often highly specialized capital are so heavy. Any influence producing instability in such an organization and under such conditions means widespread havoc. An ill-conceived tax plan has always been serious, but now its possibilities for harm to employees, to investors, and to the general public are multiplied enormously.

A second significant change is the large number of industries which we now class as public utilities and whose selling prices we control through state and federal commissions. Transportation, express, electricity, gas, and other commodities and services are only a few of a list to which war is rapidly making numerous additions. Control of the selling prices of these products without control over their costs might quickly bring disaster. A financial policy that encourages or permits inflation is especially serious to such companies. Some of them are, of course, overcapitalized and many of their burdens ought never to have been assumed, but correction of these mistakes is a slow and painful process. In the meantime their financial obligations must be met or bankruptcy ensues. No matter whose the blame, the situation calls for careful treatment. A rapidly rising price level means that these utilities must pay more for labor and materials. Some of them, prior to actual need, will ask for permission to increase rates, but if inflation continues the need will become real and relief must be granted. The demand for a fiscal policy that will prevent inflation is greater than ever before in history.

These two changes merely suggest the extent to which our economic life has been altered and indicate the intricacy of our business organization. There may be added the significant fact that in this organization emphasis is placed on the importance of individualism and on pecuniary gain as the dominant motive. In the stress of world conflict we are endeavoring suddenly to shift the emphasis from the individual advantage to social welfare. Moreover, there is a public conscience to be dealt with, more intelligent and more sensitive than ever before.

It may be easy to exaggerate the significance of these changes, but it would be folly to minimize them. Haphazard methods will be more disastrous than before and an abused and long-suffering public will be less than ever tolerant of mistakes.

To meet this unprecedented situation, what have we done? First, it may be said that more of our proposed expenditures are to be met from taxation than many of us dared to hope. Perhaps more than this

would have been unwise last year, but for the future the present amount is too small both absolutely and in its relation to the total. This is not in accord with the views expressed by Professor Adams, whose judgments, especially under the present circumstances, call for the most careful consideration. Stated briefly, the reasons for differing are as follows: (1) With a few minor exceptions the present generation must bear the war burdens. (2) Assuming a reasonably intelligent tax system, this burden will be borne more equitably through heavier taxation than through continued large loans. (3) As stated by Professor Adams, loans will produce more inflation than taxes. Exception may be taken, however, to his view that we must rely entirely upon sound banking methods to prevent inflation. It is unfair to employ fiscal methods that encourage inflation and then place upon our bankers all of the responsibility for the results. (4) In a large number of instances business has not suffered and will not suffer to the extent that has been claimed. When so many corporations are subscribing to bond issues and are distributing these bonds in dividend payments, there is a strong presumption of ability to pay taxes. The funds raised must in any case come from the national income, and the task is the delicate one of determining the particular source from which it may be taken.

In spite of these reasons for still heavier taxes the fact remains that Congress is to be commended for having done so much. Nevertheless our new law is in most of its sections merely an attempt to utilize the old sources of revenue, most of which are now used to the limit or nearly so. Exceptions to this are the income tax, which seems capable of further expansion, and the excess-profits tax, the latter being the only real innovation in the law. That new devices for securing revenue are needed also seems clear from foreign experience. England, for example, is searching for new methods and some of her leaders are now very seriously discussing a "Capital Tax, varying from, say, 1 per cent on fortunes between £300 and £1000 up to 20 per cent on fortunes in excess of £100,000; the assessment being confined to the capital values of real estate, mortgages and securities of all kinds, and ships and businesses not represented by company stocks and shares, to the exclusion of furniture, pictures, jewelry and personal effects.²

Such a proposal may seem radical and perhaps is unsuited to conditions either in England or in the United States, but it is certain

² *The New Statesman*, December 8, 1917, p. 227.

that a complacent reliance on the old sources of revenue will be disastrous and that new ones must be found.

1. The present law should be improved in certain particulars some of which have been indicated by Professor Adams. Discriminations in favor of unearned incomes should be removed and proper allowance should be made for amortization charges.

2. There should be introduced as promptly as possible a distinction between unearned and earned income. If the present income tax rates are to be retained on earned income, still higher ones should be imposed upon the unearned and perhaps be made even more progressive than at present.

3. Estate taxes might be increased. This will undoubtedly add to the problems of the states which use this source of revenue, but the federal problem is too important to warrant hesitation.

4. Frank recognition should be given to the fact that the federal fiscal problem is only part of a much larger and broader problem. Stern as it may seem, we must repress nonessential industries, restrict credit, and give priority. The more quickly this is realized, acquiesced in, and accomplished, the better for us and for our allies. Procedure in other matters should be adapted to our plans for taxation and vice versa.

5. Expert aid should be utilized more fully. The federal administration has been very ready to use outside assistance. Advisory boards have aided and are aiding the government in handling difficult problems in other fields. In fiscal matters experts are assisting in many ways, but a broader work is needed. A carefully selected group of men chosen because of their special knowledge of the subject, both in its theoretical and in its practical aspects, could render service of incalculable advantage. Their survey would be broad and their plans more thoroughly and consistently worked out than is possible under the present methods.

ARTHUR N. YOUNG.—Those responsible for framing the revenue law of October 3, 1917, deserve the gratitude of the American public and the appreciation of students of finance because of the enlightened spirit in which this legislation was conceived and because of the careful attention given to the perplexing problems of social justice. A war-tax system has been initiated whose weight bids fair to be distributed according to the burden-bearing ability of the people. Any criticism of the law should regard the difficulties which faced the government in working out a fiscal program of such magnitude. It should

be constructive and not merely destructive, having in mind that the law is not a finality. Already changes are being discussed, and mounting war expenditures will force a revision at no distant date.

We appreciate more than ever before the great advantage of having developed the administrative machinery of the income tax. Yet, considering its newness, it is not strange that a consistent theory as to the relationship between the personal income tax, the corporation income tax, and the excess-profits tax has not yet been worked out. The difficult problems of incidence here found demand a better solution than they have yet received. Satisfactory answer to the questions to which Professor Adams has given such thoughtful attention—the treatment of the corporation as compared with the partnership and the sole trader, of the investor as compared with the active business man, and the attempt to tax the excess earnings of individuals—depends upon the attainment of clearer conceptions as to the broad purposes of our taxes.

The famous “joker” clause, which levies a flat tax of 8 per cent upon earned incomes of more than \$6000, ought at once to be repealed. Taxpayers have offered willing shoulders for the great burdens about to be imposed, and such a palpably unfair clause may prejudice many against the whole scheme of tax legislation. Instead of this provision, heavier rates upon unearned incomes should be introduced in some simple form, as Professor Adams has suggested.

For the incomes of 1918 there should be considerably higher rates both for the normal tax and for the lower part at least of the scale of graduated taxes. In our taxation of incomes of up to \$50,000 we are more tender-hearted than most of us realize. Under the first British Finance Act of 1915 the rates upon earned incomes of \$4000 (£800) and \$15,000 (£3000) were, respectively, 7.5 and 12.5 per cent. But under the present American law a married man with \$4000 will pay at the rate of but 1 per cent, and with \$15,000 only about 5 per cent. Our rate does not attain 10 per cent until we reach incomes of nearly \$50,000, and in the year 1915 only 10,671 in a total of 336,652 taxable incomes were in excess of this figure.¹

The present excess-profits tax differs little in principle from the original excess-profits tax imposed by the Act of March 3, 1917. This law defined excess profits as those in excess of 8 per cent on capital, and taxed them at a flat rate of 8 per cent. The most fundamental aspect of the present law, I believe, is the measurement of normal profits as a percentage upon capital rather than as an average of pre-

¹ *Annual Report of Commissioner of Internal Revenue for fiscal year ended June 30, 1916*, p. 32.

war profits. I cannot agree with Professor Adams either in regarding the choice between these methods as "of secondary importance," or in preferring the invested capital basis to the pre-war profits basis.

It is true, as Professor Adams states, that there is little essential difference between average income and true capital. But true capital, which means capitalized net earnings, is a very different thing from the idea of invested capital as defined in the law. The whole matter centers upon the problem of the rate of return. Professor Adams states that we can ascertain the "fair return" from the files of the Bureau of Internal Revenue. But these files cannot give us the fair *rate of return*. To get that we must know the other factor, average capital, during the pre-war period and during the taxable year. Here we are at the mercy of our friends the corporation accountants; and I feel much less confidence than Professor Adams has expressed in his present paper as to the goodness of the capital accounts of our business enterprises.

The difficulties of using the capital basis were well stated by Professor Adams in a paper read at Chicago last June.² He said:

Which basis should be selected is largely a question of administrative expediency. And to that question, in this country filled with corporations whose capital accounts mean nothing, there is only one answer—*Avoid the capital basis whenever by human ingenuity it is possible to do so.* (Italics mine.)

. . . The American law of March 3, 1917, and House Bill 4280 are characterized by the following fundamental defects: they base the tax upon the original investment [*sic*] and recognize neither appreciation nor depreciation, neither the building up, nor the extinction of, intangible assets. Consider this a moment. There are hundreds of important corporations which have no true record of actual cash paid in. For these we should be forced either to construct an exceedingly expensive and difficult financial history or else turn to guesswork, in which the corporations with the largest volume of water would do the tallest guessing and get the highest exemptions. In other cases the original investment has greatly depreciated, and here the government would lose enormous revenues. Still others have built up intangible assets, such as trade-marks and good will. If such a corporation had happened to pass through a reorganization in which a "cash consideration" figured in some way, the intangible asset would be recognized; otherwise not. Here a fortuitous detail of procedure, the occurrence of a conversion or sale, might make all the difference between a heavy tax and no tax.

Nothing so discredits good taxes and so demoralizes good taxpayers as inconsistencies of this kind—the unlike treatment of like situations,

² "The Income and Excess-Profits Taxes," "Financial Mobilization for War," papers presented at a joint conference of the Western Economic Society and the City Club of Chicago, June 21-22, 1917, pp. 116-18.

the turning of the tax upon inconsequential details, the failure to recognize controlling facts, the willingness to recognize meaningless formalities. . . .

The preceding defects may be remedied by employing an income rather than a capital basis.

We are fortunate in finance, as in military matters, to be able to profit from the experience of Great Britain. The English war-profits tax applies successfully the principle of taxing the amount of war profits in excess of the average pre-war amount. It is not indeed as simple in administration as some of its champions have urged. But its satisfactory working is certified by the fact that it has continued with no essential change in principle since its adoption in December, 1915, and that it has been possible to raise the rate from 50 to 60 per cent, and finally even to 80 per cent. Should our new law prove unsatisfactory we will may turn to a war-profits tax patterned after the English model.

EDWIN R. A. SELIGMAN.—I desire to congratulate Professor Adams on his brilliant paper and I think that I am voicing the sentiment of the entire Association in expressing our gratification that the federal government has seen fit to avail itself of the services of so distinguished an expert. It will certainly tend to smooth the thorny path of federal tax administration.

Let me also say that in its fundamentals I am in thorough accord with the paper. These fundamentals I take to be three in number: first, that the excess-profits tax is a business tax; second, that it is an excess-profits tax rather than a war-profits tax; and third, that it therefore has a prospect of permanency. The first two points deserve perhaps an additional word of comment.

Among the many classifications of taxation, one of the most important is that into the taxes on persons and taxes on things—the legal distinction between taxes *in personam* and *in rem*. What has not always been recognized, however, is that taxes *in rem* include not only a land tax, as levied in New York, but also a capital tax as levied in various places, as well as a business tax. Wherever the subject of taxation is the thing, irrespective of the person who is directly related to the thing we have a tax *in rem*. A general income tax, for instance, ordinarily includes not only an individual-income tax but also a corporate-income tax, and this corporate-income tax is really a tax *in rem*. A recognition of this fact would have saved much confusion in a general discussion of the income tax. The excess-profits tax is not only a business tax, but a tax on the thing; and Professor Adams might have pointed out that in both respects it does not differ essentially from the corporate-income tax.

In the second place, the tax is not one on excess war profits but on war excess profits. The distinction is obvious. A tax on excess war profits is a tax on the excess of profits made during the war over profits in the pre-war period. A war excess-profits tax, on the other hand, is a tax imposed during the war on excess profits in general. The fact that the enactment of the tax comes during the war carries with it no implication that it is not to be continued after the war, just as our new so-called war estate tax or war excise taxes simply mean that these taxes have been imposed during the war without any guarantee that they will cease after the war. A war-profits tax automatically stops after the war because there can be no more profits due to the war. But an excess-profits tax, even though first imposed in war time, may continue as long as there are any excess profits—that is, any profits in excess of some normal standard other than pre-war profits.

While Professor Adams is entirely correct in these points, there are two criticisms of his otherwise admirable paper that I should like to urge.

The first criticism is to be directed against his attempted analogy between the excess-profits tax and special assessments, which is again connected with his idea that the tax is supposed in some way to realize the principle of benefits. Both of these positions seem to me to be untenable and based upon inadequate analysis.

No achievement of modern finance is more enduring and certain than the distinction that has been made by economists and lawyers alike between special assessments and taxes. And nothing is more firmly established than the substitution of the ability theory for the old benefit theory in taxation. To do as Professor Adams now attempts, and to blur these sharp distinctions, is to reopen the Pandora's box of confusion.

The distinction is after all a very simple one, so far as the principle of benefit is concerned. Where the government performs a definite service for the individual by which a distinct and measurable special benefit is conferred on him, the payment is called a price or a fee. Where there is measurable benefit accruing to an individual as a member of a definite area from a group service rendered, and calling for an outlay, by the government, the payment is a special assessment. Where there is no particular service rendered or where, even if there be a service to a definite group, the benefit accruing to the individual is either not separately measurable or exists only as an incidental result of governmental action, the payment is a tax. In a tax the criterion is always ability to pay. In prices, fees, and special assessments—

however they may differ from each other—the criterion is always special benefit conferred by a particular service.

Professor Adams indeed vaguely recognizes this when he tells us that the excess-profits tax is not opposed to the ability theory. But he doesn't get the situation quite straight. As was pointed out by me over twenty years ago,¹ the theory of ability includes not only the consumption or sacrifice side but the production or privilege side. That is to say, ability depends not only upon the relative burden imposed in parting with the property but upon the relative ease of acquiring the property. To the extent that the excess profits mark a greater ease of acquisition through the privileges enjoyed as a result of the economic environment, they increase the taxpayer's ability to pay. But this must not be confused with the benefit characteristic of the special assessment. There is no special service rendered for the particular individual and calling for any definite outlay by the government. All that Professor Adams really means to imply is that ability is influenced by privilege. But the excess-profits tax does not differ in this respect from many other taxes, and it does not constitute by any means the new departure that he represents. Let us not confuse benefit conferred by a particular service with privilege resulting from a general environment. To do this is to set back a long distance the progress of fiscal science.

My second criticism is more incisive. It refers to the criterion of excess profits chosen in the law. The preceding speaker has called attention to the embarrassing fact that only a few months ago Professor Adams took a position the opposite of that which he now occupies. Now I am perfectly frank to confess that a scientist, like the fair sex in general, has a right to change his mind; but when the change of mind consists in replacing truth by error, the result is a little unfortunate. And I cannot help believing that Professor Adams is in this predicament.

For what is the situation? The essential part of the law is the choice of capital as a criterion. Although Professor Adams told us a few months ago that we must avoid the capital basis "whenever by human ingenuity it is possible to do so," he now tells us that the choice is immaterial, for capital is nothing but capitalized income. In reality, however, capital is not capitalized income; it is the capitalization not only of present income, but of anticipated future income, which is a very different thing. If, as frequently happens, the anticipated future

¹ *Progressive Taxation in Theory and Practice*, 1894, p. 191. Cf. 2d ed. 1908, p. 282, and *Essays in Taxation*, 8th ed., 1913, pp. 340, 418, 438-44.

income does not materialize, there is a very vital difference between a tax on capital and a tax on income. The new tax, therefore, is not only a clumsy attempt to reach taxable ability, but, under actual conditions, it introduces gross inequality in principle and deplorable uncertainty in administration.

The chief objection, however, to the law is one that has escaped Professor Adams' notice. Even assuming that capital could be accurately estimated and that it varied proportionally with income, the tax would still be seriously defective. This is due to the criterion chosen for the basis of the graduated scale. Something may be said for a graduated tax on income; something may even be said for a graduated tax on capital; but little, if anything, can be said in defense of a tax graduated on the varying percentage which income bears to capital. To penalize enterprise and ingenuity in a way that it is not accomplished by a tax on either capital or income—that is the unique distinction of the present law. For while the excess profits contemplated by the law are sometimes the result, in part at least, of the social environment, they are not infrequently the consequence of individual ability and inventiveness. And while it is perfectly proper that a share of the profits should go to the community, it is not at all clear that the tax should be graduated according to the amount of inventiveness. But, furthermore, almost all large businesses have grown from humble beginnings; and it is precisely in these humble beginnings that the percentage of profits to capital has been the greatest. The criterion selected by the new law, therefore, is the one best calculated to depress industry, to check enterprise at its very inception, and to confer artificial advantages on large and well-established concerns.

How much simpler and better it would have been to make the excess-profits tax a part of a progressive business income tax, and to apply to corporations a scale of graduation which would in principle at least not differ fundamentally from that of the individual income tax. To develop this idea would take me too far astray. It may, however, be confidently affirmed that while such a scheme would no doubt encounter certain difficulties of its own, it would not be open to any of the fundamental objections to the present plan. Professor Adams' evident desire to show intense patriotism by a blanket approval of the law is purchased, I fear, at the cost of a little less than his customary solicitude for scientific precision.

HENRY H. BOND.¹—It is with considerable reluctance that I venture to criticise the interesting conclusions of so eminent an authority on taxation, but possibly one may be permitted to differ on a subject concerning which there is no consensus of authoritative opinion.

¹ This discussion was not presented at the meeting.

In the difficult matter of a special-profits tax, we now stand committed, at least experimentally, to a tax upon excess profits rather than one upon war profits. In this we are running counter to the successful experience of Great Britain, and embarking on an independent and uncharted course.

But if war revenue is needed, what is more natural or equitable than to seek it in part where war profits accrue? Why should an industry whose prosperity depends solely on the war bear no extra burden? If there is one feeling that is common among all thinking Americans, it is the natural repugnance to the idea of pecuniary profit from an enterprise of blood and violent death, built up on the highest idealism that America has yet advocated. And yet this feeling has been ignored by Congress in this important taxation measure.

But Professor Adams, while carefully avoiding the rôle of prophet, rather indicates a belief that this form of taxation is to be permanent, and partially justifies its choice over a war-profits tax upon this ground. While Congress carefully expunged from the text a phrase that might have been construed as an assurance of duration for the war only, yet we have certainly been given to understand that war revenue was the purpose and justification of this additional burden. The very fact that this tax and the secondary income tax were kept distinct and separate from the income tax of October, 1916, was in itself such an implied assurance. If these taxes are to be, in some form as Professor Adams now seems to believe, a permanent asset—or liability—has not the government been indulging in a camouflage that has results that are unfortunate for a loyal public?

For we must not shut our eyes to the fact that our federal taxation system has, by this separation of legislation, acquired a complexity that is exceedingly serious. Speaking as one who has had some administrative experience under a rather complicated income tax, I appreciate keenly the desirability—the almost necessity—of simplicity in taxation matters relating to large numbers of persons. It was an administrator of Professor Adams' own state of Wisconsin who gave me the excellent advice, "Do not create a tax that will be so complicated that a man must pay a lawyer five dollars to learn that he has no tax to pay!"

But upon the interpretation of this federal act, now upon the statute books for many months, the department officials are themselves in disagreement, and even such an expert as Professor Adams is led to speak with caution and express grave doubt as to the probable construction of certain of its most vital features. Such complexity forcing, as it does, the taxpaying public to rush for expensive expert ad-

vice only to find that its experts are themselves in disagreement, can produce nothing but disturbing uncertainty, all the more to be deplored if the tax is to be a permanent one.

But only secondary in importance to the form of the tax itself is its standard of invested capital as a measure of its taxable income. I am forced reluctantly to disagree with Professor Adams in his statement that the question of whether a tax is based on capital or on income is of secondary importance, and that income usually reflects capital employed. If we are to take our average broadly enough, over a varied line of industries, and especially over a sufficiently long period of years, the statement is undoubtedly true. Capital will seek a level of income, or rather, at points of low yield, will tend to be gradually diverted into more profitable channels. But channels of low yield combining high safety will always exist beside those of high yield and low safety, attracting distinct types of the investing public; special temporary conditions will always arise from time to time to disturb the natural law of the gravitation of capital to alluring fields; and capital once invested often assumes so permanent a character that its change to another more profitable industry is slow and difficult of accomplishment, if not impossible.

As a result of these factors, we find the yield of capital variously employed to be widely variant. A minute examination of the income of all of the Massachusetts corporations for the past three years, recently made under our supervision, reveals a scale running from severe losses to a profit of as high as 7500 per cent of the invested capital within a single year's figures. Are we, then, justified in assuming that normal income bears, on the whole, a definite relation to invested capital, so that we may tax the excess of income—supernormal profits—as deserving of a special burden?

Especially is the use of "invested capital" as a determining factor objectionable because of its exclusion of borrowed capital from its definition. I have in mind two partnerships—one composed of three young men of unblemished reputation and integrity, who, by a truly remarkable industry and reliability, have been able, on a small amount of capital, to finance a large volume of business, with a resultant profit that is out of all relation to the capital—exclusive of large borrowed capital—employed. Their public spirit is shown in large purchases of Liberty Bonds, the support of an ambulance unit abroad, and the sale of merchandise to the government for use in the war at cost. Their excess-profits tax will be exceedingly heavy, and will of necessity entail large reductions in their patriotic subscriptions henceforth. I contrast this concern with another, whose indebtedness is now capitalized;

so that, for a profit approximately as large, they will be liable to an excess-profits tax some 60 per cent less in amount.

A tax which thus uses as a determining factor an element which yields so easily to manipulation and readjustment discourages open business methods, and correspondingly encourages legalized evasion. Hundreds of corporations have hastened to put their houses in order for the inspection of the excess-profits tax collector, and have found the methods only too easy of adoption. The line between borrowed and other capital is too easily shifted to be a safe or enduring test, and the difference one of form rather than substance.

But even between various lines of industry, will the tax on excess profits work equity? It is exceedingly doubtful. An eminent authority has pointed out very clearly that our large corporations have a relatively large investment of capital, and, sheltered in some staple and necessary line, earn a proportionately small return upon the funds involved; while by far the larger percentage of profits more usually arises in some special line, on a relatively small capital. These are the industries, then, which will bear the brunt of the burden, and this is not as it should be or as Congress expected it to be.

Professor Adams justifies the tax as being the community's share in the benefit conferred upon the industry. But too often the only benefit that has been conferred is the right to existence—an existence which is in the main employed in securing "all that the traffic will bear," to use a familiar phrase—in retailing to a public needful of food and clothing these cardinal necessities. I have seen the figures which show corporations dealing in food, clothing, shoes, coal, wood, paper, to have made from 100 to 500 per cent upon their invested capital in these war times. If these conditions are warranted, and do not justify stringent price restriction, then is not the state in questionable company when it shares in the spoils? And can it be said that the community has conferred a "benefit" upon the industry which entitles it to such a division of profits?

There are, of course, countless instances of industries dependent upon legitimate protection or the use of patent rights where the community benefit is clearly conferred and such sharing should properly ensue. But should we not hesitate to justify impliedly a claim for a share of profits where the mere right of existence alone is present, and such right is so broadly abused?

Again, is it not clear that in many cases supernormal profits will exist only in an increased inventory total, due to rising market prices? To tax such increase so heavily ignores the fact that a corresponding decrease in a subsequent year will not offset a tax previously paid, since each income year is of necessity treated as separate and distinct.

All that Professor Adams says as to the tax deterring from enlargement of plant is undoubtedly true. Even though such enlargement is deductible from the special 10 per cent tax on undistributed profits, it remains true that earnings represented by an enlarged plant—enlarged perhaps as a direct contribution to the nation's need in war supplies—are taxable at a heavy rate, and a corporation may be well-nigh crippled thereby.

Net income is not necessarily cash in the bank, as certain members of Congress seemed to assume. The financing of the corporations in the matter of raising funds to pay the excess-profits tax is itself a serious problem now causing the highest officials of the government grave concern.

The tax upon undistributed profits may prove to be an unfortunate selection, apparently adopted because of a desire to reach prematurely the earnings of large stockholders subject to the super-tax. It fails to recognize that such earnings are often withheld from distribution partly for the purpose of safety and partly to equalize the dividend distributions of various years. It cannot be denied that such a practice is in many instances not only legitimate but so properly conservative as to deserve encouragement rather than an additional burden. To penalize such a method in such cases is to encourage irregularity in dividend distributions and a proportionate lack of safety as well as difficulty in financing for future legitimate needs and growth.

Professor Adams sees no answer to the question why the farmer should pay an excess-profits tax and the salaried man none. Is not the answer possibly this: that the person who sells a commodity receives a price and profit dependent upon market conditions—competition and the urgency of the public's desire; but the salaried man has no such market conditions to face, and in selling his services receives in principle the true value thereof? There is, then, in such a case no possibility for an excess profit and the application of an excess-profits tax is incongruous. If the salary is earned, where is the excess to be found? The case is far different from that of the manufacturer of a patented article costing perhaps a dollar to produce and selling for the price of five dollars; the sale of a food product of limited supply, and to some extent "cornered," for a price double the normal; or the sale of articles of clothing at a profit of several hundred per cent of the invested capital involved. The salaried man can never force the public to pay such an unwarranted price for the article which he has to sell. Salaries change but slowly partly because decreases are usually made only for poor service and not due to a change in market conditions.

If I have thus emphasized the various aspects of the law on which

I feel somewhat in disagreement with Professor Adams, I have not failed to appreciate the many helpful suggestions which he has made as to future amendments and policy and the many arguments which he advances with which I am in hearty accord and on which I have, therefore, offered no word.

To me, the discouraging feature of the taxation situation has been the unwillingness of Congress to accept a profit by such expert advice as men such as Professor Adams are in a position to give, and to which I trust a more willing ear will be given in the future.

CARL G. BARTH.—By a mere accident, I some time ago became interested in the personal income tax, and was at once struck by the lack of mathematical relations between the percentages that were levied last year as well as those to be levied this year, though the latter are far less defective in this respect than the former. However, I shall confine my remarks to the latter.

The final combined rates listed with their successive differences below, are enough to point out what I have in mind.

2 - 4 - 5 - 6 - 7 - 8 - 9 - 12 - 16 - 21 - 26 - 31 - 35 - 41 - 46 - 50 - 54 - 59 - 65 - 66 - 67
 2 - 1 - 1 - 1 - 1 - 1 - 3 - 4 - 5 - 5 - 5 - 4 - 6 - 5 - 4 - 4 - 4 - 6 - 1 - 1

We also observe the same lack of regularity in the differences between the incomes at which these rates change from a lower to the next higher.

After some looking around for a *simple* empirical formula that would approximately average up to the rates of the present law, I hit upon the following, which seems to answer very well for the \$2000 exemption:

$$T = (C - 2000) \frac{2}{3} \times \frac{C + 10000}{C + 360000}$$

in which T = Tax, C = income.

The annexed table gives simultaneous values of the tax to be levied and values of this formula, and also the ratios of these values. The fact that the latter values are first greater than the former up to an income of \$5128, then are less between this and an income of \$192,687, then again greater up to \$2,251,000, and finally less from that income up to ∞ , seems to indicate that a formula of the form $T = (C - E) \times \frac{C + a}{C + b}$ would be quite suitable as a basis for a graded tax, even if it should not be considered well to employ it directly, which I, however, herewith advocate.

That the particular form of this formula, which in the table has been compared with the present tax, gives values so decidedly lower than

the present tax for incomes for which Professor Young suggested that the tax rate might justly be raised, seems to indicate that his suggestion is not well founded.

From an extended study of this formula and numerous others that I have had under consideration, I have gotten certain ideas about taxation which I would like to present to this meeting, but the time allowed me being so limited, I can only add that I am further confirmed in the belief I have held for years, that unless a proposition dealing with numbers of any kind is reduced to some kind of a mathematical formula, and this plotted on a diagram, a complete grasp of the proposition cannot be entertained.

When I first took this matter up, I was fortunate enough to secure an interview with Professor Adams in his office in the Treasury Department in Washington, and to receive his encouragement to develop my ideas further, and on February 26 I shall present them fully before a local meeting of the American Society of Mechanical Engineers in Philadelphia.

| Income | Present Law | Formula | Formula derived by Present Law |
|----------|-------------|-------------|-----------------------------------|
| 2000 | 0 | 0 | 1 |
| 3000 | 20 | 23.87 | 1.194 |
| 4000 | 40 | 51.28 | 1.282 |
| 5000 | 80 | 82.19 | 1.027 |
| 5128 | 86.40 | 86.40 | 1 |
| 7500 | 205 | 174.60 | 0.852 |
| 10000 | 355 | 288.29 | 0.812 |
| 12500 | 530 | 422.82 | 0.798 |
| 15000 | 730 | 577.77 | 0.791 |
| 20000 | 1180 | 947.37 | 0.803 |
| 40000 | 3580 | 3166.67 | 0.885 |
| 60000 | 6780 | 6444.44 | 0.951 |
| 80000 | 10980 | 10636.36 | 0.969 |
| 100000 | 16180 | 15623.19 | 0.966 |
| 150000 | 31680 | 30954.25 | 0.977 |
| 192687 | 46620.44 | 46620.44 | 1 |
| 200000 | 49180 | 49500.00 | 1.007 |
| 250000 | 69680 | 70469.94 | 1.011 |
| 300000 | 92680 | 93313.13 | 1.007 |
| 500000 | 192680 | 196883.72 | 1.022 |
| 750000 | 327680 | 341429.43 | 1.042 |
| 1000000 | 475180 | 494107.84 | 1.04 |
| 1500000 | 800180 | 810745.52 | 1.013 |
| 2000000 | 1130180 | 1134457.62 | 1.004 |
| 2251000 | 1298350 | 1298350.31 | 1 |
| 5000000 | 3140180 | 3114425.37 | 0.992 |
| 10000000 | 6490180 | 6440148.01 | 0.992 |
| 20000000 | 13190180 | 13102815.32 | 0.993 |
| | | | 0.995 |

ROY G. BLAKEY.—Professor Adams states that the present war taxes and possible future taxes are preventing the building and extension of plants whose production is sorely needed by the government, and he urges that we cease agitation for higher taxes. Inasmuch as those of us at Minnesota were chiefly responsible for the circulation and presentation of a memorial of American economists to Congress last April, a memorial which urged that Congress finance the war chiefly through taxes rather than through loans, I cannot let this occasion pass without calling attention to one or two matters. In view of what Professor Adams has said upon other occasions I am somewhat surprised to find that in his paper of today he seems willing to acquiesce in the present proportion between taxes and bonds, that is, about one to four or five. I am reluctant to urge my opinions backed by a limited experience as compared with the rich experience of Professor Adams; and, because of my respect for his judgment and experience, I am hesitant to continue agitation for higher taxes until those now on the statute books can be put in operation. I know that this will cause some to charge me with inconsistency, but I realize that administration is of prime importance and that the present rates well administered will be better than higher rates poorly administered.

One of the most serious difficulties, as Professor Adams has pointed out and as I have stated also on several different occasions, is the failure to allow for proper depreciation, or obsolescence, in the case of plants needed for war work. Ordinary rules of depreciation are inadequate for a plant that may be in operation for only one or two years. The whole cost might be written off the first year. Or the government might subsidize or take over, at least for the period of the war, those plants which are making the prime military necessities. Such plants should be given special treatment. But this does not mean that on this account the general rates of taxes on excess profits and incomes are too high in most cases. It does not mean that we should desist from raising an even larger proportion of our war costs through taxes if appropriate treatment is given special cases.

As I have stated upon previous occasions, I think that drastic taxation should be levied to suppress unnecessary industries, and that in many cases even such taxation would not be sufficiently prompt in reaching desired results, hence direct prohibition through priority regulation or otherwise should be adopted.

It is true that our memorial to Congress was stated somewhat radically, more radically than I would state it now in view of the larger estimates of war costs and in view of the inertia of public opinion.

But I am convinced that the chief difficulties in the way of more adequate taxation are psychological, and that some of these may be removed by the education of the public as to the real burdens of war finance.

We now look back upon our former wars, the Revolution, the War of 1812, and the Civil War, and condemn Congress, our financiers, and the people for not adopting vigorous taxation at the beginning. If the present war should end soon we may get off without great financial disaster and with a minimum of economic disturbance. But if it continues for several years, as many think it will, the present taxation which so many think is heavy will appear insignificant in comparison with what it should have been. In such case it is not at all unlikely that the next generation will condemn us with as much or more reason than we condemn the past for shortsightedness, inability to learn from experience, and unwillingness to do social justice.

N. I. STONE.—Professor Adams stated in the course of his remarks that “capital is but capitalized profits.” I hope he did not mean literally what he said, for the practical application of this principle, if literally interpreted, it seems to me, would cut the ground from under the excess-profits tax. The excess-profits tax is based upon the idea of a profit in excess of what is regarded as a normal profit; but if all profits made in a business, be they high or low, can be capitalized, they will assume the form of a normal return upon the capital thus defined. There will be no excess profits under this construction of capital, and the excess-profits tax will automatically vanish.

R. R. BOWKER.—Agreeing fully with Professor Adams, that the excess-profits tax has come and should come to stay, whether in its present form or with modifications, in line with Professor Seligman’s suggestion, may I point out—very modestly as becomes a mere business man in the high presence of professors—that this tax is thoroughly in accord with a general scheme of taxation which has been in process of quiet evolution in this country without much attention to the general principle underlying it. We have heard much of social justice as an economic aim, and a system of taxes which involves exemption as a minimum of normal returns, and differential or graded taxation of supernormal returns is thoroughly in accord with that aim, preventing the rich becoming richer in inordinate degree and the poor becoming poorer. This is the underlying principle, applied through rent, of the Henry George scheme, a scheme which he sought to con-

fine to a single tax on land as the key to the entire economic situation. The "single taxers" have evoked an ardent enthusiasm which has become almost religious fervor, as in the interest of social justice. Those of us who are known by the contradictory term of "limited single taxers" may gladly see the underlying principle applied to other subjects of taxation, as a measure of sound economics as well as social justice. The theory of the social increment seems applicable to other returns than those from land, for the man who enjoys a supernormal income or who has amassed a large fortune to bequeath to his heirs, or the corporation which earns excess profits, does so because the community contributes to the result by its coöperation or patronage, in proportion to the largeness of the return. A manufacturing corporation may return to the public this benefit from the public by decreasing the price of its product as proportionate cost decreases, or through taxes proportionate to its excess profits. This form of taxation goes far to meet the just complaints and sound desires of the Socialist Party, without adopting the extreme principles of collectivism which would diminish if not destroy the economic value of individual effort, and should be in the interest of good politics as well as sound economics. For these reasons, I have long believed and for years past have expressed the belief that the general scheme of taxation exemplified in the excess-profits tax—perhaps limited in amount to a maximum of 50 per cent, so that productive efforts shall not be discouraged—may prove the solution of many of our economic difficulties and political problems, and ultimately replace other and less just methods of taxation.